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IN THE
Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS AND KATHERINE V. DAVIS,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF KENTUCKY

MOTION FOR LEAVE TO FILE AND BRIEF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS AS AMICUS CURIAE SUPPORTING PETITIONERS

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MOTION OF THE NATIONAL ASSOCIATION OF STATE TREASURERS FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

The National Association of State Treasurers ("NAST") hereby seeks leave, pursuant to this Court's Rule 37.2, to file the attached brief as an amicus curiae in support of Petitioners, Department of Revenue of the Commonwealth of Kentucky and Finance and Administration Cabinet of the Commonwealth of Kentucky. Petitioners have consented to the filing of this brief, but Respondents have declined to grant their consent. Correspondence reflecting the parties' respective positions has been lodged with the Clerk.

NAST is a nonprofit association, established in 1976, that is qualified as an exempt organization under Section 501(c)(6) of the Internal Revenue Code of 1986. NAST's members include the Treasurers or similar State financial officers of all 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and several territories

of the United States. These officials typically function as the chief financial officers of their respective States with primary responsibility for a wide range of fiscal functions, including, in most cases, the State's direct debt issuance and other capital market operations. Many of these officials are also responsible for approving, or have other oversight responsibility for, the debt issuance and general fiscal affairs of political subdivisions and other public bodies within their respective States. NAST's membership also includes corporate affiliate members that provide accounting, financial, legal, or other advisory services to NAST's public members. In view of the role and responsibilities of NAST's public members in the issuance of public debt by States and their subdivisions, NAST has a strong interest in the constitutional question presented by the Petition regarding the treatment of municipal bonds under state tax laws.

NAST's affiliate organizations include the State Debt Management Network, the professional network of public sector employees who are responsible for the management and issuance of state debt, and the College Savings Plans Network, the professional network of public sector employees who are responsible for the management and supervision of qualified tuition programs.

NAST and its affiliate organizations have a long history of conducting extensive professional education programs, of engaging in the development and implementation of best practices, and of participating in the development of federal laws and administrative regulations affecting State fiscal affairs. NAST believes that its members' extensive experience in the field of municipal bonds and similar public programs will assist the Court in evaluating the importance of the issue presented by the Petition.

Accordingly, NAST respectfully seeks the Court's leave to file the attached brief supporting Petitioners.

Respectfully submitted.

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INTEREST OF AMICUS CURIAE

The National Association of State Treasurers ("NAST") is a nonprofit association, established in 1976, that is qualified as an exempt organization under Section 501(c)(6) of the Internal Revenue Code of 1986.[1] NAST's members include the Treasurers or similar State financial officers of all 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and several territories of the United States. These officials typically function as the chief financial officers of their respective States with primary responsibility for a wide range of fiscal functions, including, in most cases, the State's direct debt issuance and other capital market operations. Many of these officials are also responsible for approving, or have other oversight responsibility for, the debt issuance and general fiscal affairs of political subdivisions and other public bodies within their respective States. NAST's membership also includes corporate affiliate members that provide accounting, financial, legal, or other advisory services to NAST's public members. In view of the role and responsibilities of NAST's public members in the issuance of public debt by States and their subdivisions, NAST has a strong interest in the constitutional question presented by the Petition regarding the treatment of municipal bonds under State tax laws.

NAST's affiliate organizations include the State Debt Management Network, the professional network of

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[1] Petitioners have consented to filing of this brief, while Respondents have declined to consent. Letters reflecting the parties' respective positions have been filed with the Clerk. Pursuant to this Court's Rule 37.6, NAST states that no counsel for a party authored this brief in whole or in part. Nor did any person or entity, other than NAST, its members, or its counsel make a monetary contribution to the preparation or submission of this brief.

public sector employees who are responsible for the management and issuance of state debt, and the College Savings Plans Network, the professional network of public sector employees who are responsible for the management and supervision of qualified tuition programs.

NAST and its affiliate organizations have a long history of conducting extensive professional education programs, of engaging in the development and implementation of best practices, and of participating in the development of federal laws and administrative regulations affecting State fiscal affairs. NAST believes that its members' extensive experience in the field of municipal bonds and similar public programs will assist the Court in evaluating the importance of the issue presented by the Petition.

STATEMENT

Two Kentucky taxpayers filed this action in the Circuit Court of Jefferson County, Kentucky challenging the Commonwealth's taxation of out-of-state municipal bonds. The Commonwealth of Kentucky, like a majority of the States, does not tax interest earned on bonds issued by the Commonwealth or its subdivisions, but it does tax interest earned on bonds issued by other States or their subdivisions. *See* Ky. Rev. Stat. Ann. § 141.010(9), (10).

The trial court granted Petitioners' motion for summary judgment. Pet. App. A15-A19. The court held that municipal bonds fall within the "market participant" exception to this Court's dormant Commerce Clause jurisprudence. *See, e.g., Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980); *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976). Accordingly, the court held, the State "clearly may pay a higher rate of interest to resident purchasers based upon the theories of distributing state created benefits and market participation." Pet. App. A18. The court observed that "[e]ach state has a legitimate interest

in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds." *Id.* at A19. Because Kentucky's taxation of out-of-state bonds has a "reasonable, legitimate public purpose," the court held that it is constitutionally permissible. *Id.*[2]

On appeal, the Kentucky Court of Appeals vacated and remanded the trial court's decision. Pet. App. A1-A13. The Court of Appeals held that Kentucky's tax on the income derived from bonds issued by States other than Kentucky is "facially unconstitutional" because "it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." *Id.* at A6.

The court rejected three arguments made by Petitioners in support of the constitutionality of Kentucky's tax code. *First*, the court declined to follow a decision of an Ohio appellate court holding that a similar taxation system does not violate the Commerce Clause. *See Shaper* v. *Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994); Pet App. A7-A8. *Second*, the court held that this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), is not on point. *Bonaparte* involved a challenge to taxation of out-of-state bond interest based on the Full Faith and Credit Clause, and the Court there concluded that "no provision of the Constitution of the United States . . . prohibit[ed] such taxation." *Id.* at 594. The Kentucky Court of Appeals held that *Bonaparte* was not on point because it did not involve the Commerce Clause. Pet.

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[2] In addition, the court found that Respondents, as individuals, lack standing to challenge parallel provisions of Kentucky law taxing corporations, trusts, and estates on income from out-of-state bonds. Pet. App. A17. The court held, however, that Respondents have standing to challenge "an individual income tax paid by them." *Id.* at A18.

App. A9. *Third*, the court rejected Petitioners' "market participant" argument. The court found that issuing bonds constitutes participation in the bond market, while taxing income derived from bonds is an activity of the State as a market regulator. Because "the sole issue is Kentucky's decision to tax only extraterritorial bonds," the court found that "the market participant theory is inapplicable." *Id.* at A10.[3]

The Supreme Court of Kentucky denied discretionary review of the Court of Appeals' decision. *Id.* at A14.

SUMMARY OF THE ARGUMENT

Although NAST takes no position on the merits of the question presented, it strongly urges the Court to grant review. State and local governments rely on municipal bonds as an essential source of funding for a wide range of public projects and programs that benefit education, transportation, health, housing, and public utilities.

The principal feature of municipal bonds that distinguishes them from other capital market securities is their exemption from federal – and, in many cases, State and local – taxation. The tax-exempt status of municipal bonds allows State and local governments to borrow funds at a lower interest rate. Exempting municipal bonds from State and local taxes makes them even more attractive to investors. The importance of State tax exemptions is demonstrated by the popularity of mutual funds that invest in the municipal bonds of a single State.

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[3] The court also reversed the lower court's ruling on standing, concluding that "the trial court had confused the concept of standing with the somewhat related issues involved in class certification." Pet. App. A11. The court of appeals held that Respondents "have standing." *Id.* at A12.

The decision of the Kentucky court of appeals calls into question the tax treatment of municipal bonds in more than 40 States that grant a tax exemption for some or all in-State bonds but not for out-of-State bonds. In view of the vital importance of municipal bonds to State and local governments, and the centrality of their tax exempt status, this is an important question that should be decided promptly by this Court.

REASONS THE PETITION SHOULD BE GRANTED

NAST has not taken a position on the merits of the question presented by the Petition. Nevertheless, NAST strongly urges the Court to grant review in this case. The issue presented is very important to State and local government entities that issue municipal bonds and to citizens who benefit from government projects and activities financed by municipal bonds. The decision of the court below has created legal uncertainty that should be resolved promptly, and can only be resolved by this Court. Accordingly, the Petition should be granted.

I. Municipal Bonds Are An Essential Source Of Funding For State And Local Governments.

Municipal bonds are interest-bearing debt obligations issued by State or local government entities. These entities include the States themselves, State-created authorities, incorporated local municipalities and local authorities.[4] A municipal bond represents a promise

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[4] Bond-issuing entities include, in addition to States and their political subdivisions, public authorities established by specific authorizing legislation or interstate compacts (in the case of interstate agencies approved by Congress such as the Port Authority of New York and New Jersey, Joint Resolution of Aug. 23, 1921, 42 Stat. 174), as well as certain entities established under general law for the benefit of a State or political subdivision.

by the issuer to repay the investor the principal amount of the bond and interest according to a fixed schedule.

The most common category of public debt instruments are "general obligation" bonds, which are backed by the full faith and credit of the issuer to apply all sources of revenue, unless specifically limited, to payment of principal and interest. *See* The Bond Market Association, The Fundamentals of Municipal Bonds, 55-56 (5th ed. 2001). "Revenue bonds" generally are backed by a particular stream of revenue rather than general tax revenues. *Id.* at 58. Revenue bonds typically are used to fund specific projects that the issuer expects will generate revenue to service the debt. *See id.* For example, bonds issued to raise money for an airport or toll road may be funded by airport fees or tolls.[5]

State and local governments issue municipal bonds to raise funds to support general government needs or to fund public works projects and programs. Governments fund a wide range of capital projects through municipal bonds, including educational buildings at all levels from elementary schools to colleges and universities, government buildings, transportation facilities (including bridges, highways, and airports), public utility projects, hospitals, stadiums, and low-income housing.

State and local governments increasingly have come to rely on the issuance of municipal bonds to raise revenues for a wide range of vital projects, and State and local government credit has long been recognized as "an essential source of funding" for those entities. *South Carolina* v. *Baker*, 485 U.S. 505, 531 (1988) (O'Connor, J.,

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[5] A third category of municipal bonds, "moral obligation" bonds, are payable from revenues expected to be provided by the issuer or another government entity that is not legally obligated to make such payments. *Id.* at 57.

dissenting). *See also* Pet. 8 (noting that State and local governments "rely heavily upon the issuance of debt"). In the 25 years from 1975 through 1999, the total value of new short- and long-term municipal bonds issued grew tenfold, from $26 billion in 1975 to $263 billion in 1999. The Bond Market Association, *supra* at 3. More than $350 billion of long-term public finance debt was issued by States in each year from 2002 through 2006.[6]

The total value of outstanding municipal bonds has increased as well. In 1980, the total outstanding value of municipal bonds was approximately $399 billion; by 2000, that number had nearly quadrupled, to $1.5 trillion. *Id.* at 17. State and local governments' debt obligations have continued to rise: The Census Bureau's annual survey of State and local government finances reported a combined $1.68 trillion in outstanding debt in 2001-02, $1.81 trillion in 2002-03, and $1.95 trillion in 2003-04.[7] The steady increase in municipal bond issues reflects the critical importance of this source of funding for State and local capital programs affecting health, education and public improvements.

Municipal bonds offer benefits to the issuing authority, its citizen constituents, and the purchasers of the bonds. The bond issuer is able to fund important but expensive public projects, and may be able to do so without having to raise taxes. Citizens enjoy the benefits of projects financed through municipal bonds, which may be repaid over time with tax revenues or revenues generated by the project itself. And purchasers of

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[6] *The Bond Buyer/Thomson Financial Yearbook* 14-15 (2006); Matthew Hanson, *Volume in '06 a Near Record*, The Bond Buyer, January 2, 2007, at 1.

[7] U.S. Census Bureau, State and Local Government Finances, 2001-02 (Census); 2002-03; 2003-04, *all available at http://www.census.gov/govs/www/estimate.html.*

municipal bonds benefit from a reasonably safe investment. Although the pre-tax rate of return on municipal bonds is frequently lower than is available through other investment vehicles, that difference is offset by the tax-advantaged status of municipal bonds.

II. The Tax-Exempt Status Of Municipal Bonds Is Critical To Their Success.

The most distinctive feature of municipal bonds is their favorable tax treatment, which provides them with an advantage over other types of investments. This favorable tax treatment allows issuers of municipal bonds to obtain funding for public projects at a lower interest rate than would otherwise be available to them. Federal law provides a significant tax advantage by exempting interest on municipal bonds from federal income tax. Many States also exempt municipal bonds from State (and in some instances local) taxation. The State and local tax exemptions can provide a significant additional advantage to municipal bonds as compared to other investments.

A. Tax Exemptions Make Municipal Bonds More Attractive To Investors, And Reduce State And Local Governments' Cost Of Borrowing.

Exemption from federal taxation is the principal characteristic that has long distinguished public finance debt from all other capital market securities. *See* Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law Theory and Practice* § 1.3.4 (1992); The Bond Market Association, *supra* at 27-29. Since the Sixteenth Amendment was ratified in 1913, the Internal Revenue Code generally has accorded tax-free status to municipal bonds. The Bond Market Association, *supra* at 27. *See*

also 26 U.S.C. §§ 103, 141-150.[8] The tax-free status of municipal bonds allows the bond issuer to borrow money at a lower interest rate than it could obtain from other sources of financing. Investors are willing to accept lower interest rates precisely because of the advantages they gain from the tax exemption. *Id.*

The benefits of the tax exemption are readily calculable. It is misleading to compare the published interest rate of a municipal bond to that of an investment without favorable tax treatment, because taxes on non-exempt bonds reduce the after-tax return to the bondholder. To meaningfully compare the rate of return of a tax-free bond to that of a taxable bond, investors use the following formula to calculate the rate of return on a taxable bond that will yield the same income as a tax-free bond:[9]

$$\frac{\text{municipal bond yield}}{(1 - \text{marginal tax rate})} = \text{comparable taxable bond rate}$$

For example, a bondholder with a 33 percent marginal federal tax rate in a State without income tax, who purchases a municipal bond paying 5 percent interest per

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[8] The Securities Act of 1933 includes an exception to its registration requirements for securities issued by a State or political subdivision. *See* 15 U.S.C. § 77c(a)(2). The exemption was intended to "correspond[] generally with the line drawn by the courts as to what obligations of States, their units and instrumentalities created by them, are exempted from Federal taxation." H.R. Rep. No. 73-85, at 14 (1933). *See generally* Robert A. Fippinger, *The Securities Law of Public Finance*, §§ 2.2, 2.9.5 (2d ed. 1999).

[9] *See* The Bond Market Association, *supra*, at 28-29; Fidelity.com: Taxable vs. Municipal Bond Funds, *http://personal.fidelity.com/products/funds/content/fundtypes.shtml.cvsr?refpr=ipmf4*.

year will earn interest equivalent to a taxable bond that pays approximately 7.5 percent interest.[10]

B. The Benefits Of Favorable Tax Treatment Include Exemption From State And Local Taxation.

In comparing municipal bonds to other investments, taxpayers take into account not only the federal taxes that would be due on the income, but also State and local taxes. Many States exempt interest on their municipal bonds from taxation, and a State's ability to tax out-of-state bonds can have a significant impact on an investor's decision to purchase in-state bonds versus out-of-state bonds. The "essential variable" in computing the equivalent yield between taxed and tax-free bonds is the investor's marginal tax rate. The Bond Market Association, *supra* at 27. An investor who resides in a State with an income tax who purchases bonds that are free from State taxation as well as federal taxation increases his or her equivalent taxable yield. The greater the investor's marginal tax rate, the greater the advantage of municipal bonds over other investments. *Id.*[11]

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[10] That is so because $0.05 \div (1 - 0.33) = 0.0746$.

[11] State and local income tax payments generally are deductible from income under federal law, so the taxpayer's marginal tax rate is not simply the sum of her federal tax bracket and the State tax rate. *See* The Bond Market Association, *supra*, at 29. Instead, the marginal tax rate for persons who itemize is calculated according to the following formula:

federal bracket + state rate – (federal bracket x state rate)

A taxpayer in the 33 percent federal tax bracket whose State imposes a 5 percent income tax would thus have a combined marginal rate on a fully taxable investment of 0.33 + 0.05 – (0.33 * 0.05), or 36.35%. *See id.*

Favorable State tax treatment of municipal bonds increases the marketability of municipal bonds, and exemptions from State and local taxation may be particularly important to smaller issuers and those with less than perfect credit ratings.[12] Investors have increasingly sought bonds that are exempt from State (and in some cases local) taxation, and mutual fund managers have created State-specific bond funds to meet that demand. *See* Jerry Webman, *Managing Single-State Municipal Bond Funds* in The Handbook of Municipal Bonds 339-350 (Susan C. Heide, Robert A. Klein & Jess Lederman eds., 1994).[13] The popularity of State-specific bond funds demonstrates that investors view exemption from state taxation as an important consideration when investing in municipal bonds.[14]

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[12] *See* Robert Lamb & Stephen P. Rappaport, *Municipal Bonds* 2, 25-26 (2d ed. 1987); Dwight Denison, *Bond Market Reactions to Hurricane Katrina: An Investigation of Prices and Trading Activity of New Orleans Bonds*, Municipal Finance Journal 39-52 (2006).

[13] *See also, e.g.*, Vanguard California Tax-Exempt Money Market Fund (Symbol: VCTXX); Vanguard Florida Long-Term Tax-Exempt Fund Investor Shares (Symbol: VFLTX); Vanguard Pennsylvania Long-Term Tax-Exempt Fund Investor Shares (Symbol: VPAIX). Each of these funds seeks to provide income that is exempt from federal income tax and tax in the bond issuing state, and is intended for residents of that state. Similar funds are targeted to residents of Alabama, Arizona, Connecticut, Delaware, Kentucky, Massachusetts, Michigan, Minnesota, Ohio, Oregon, New York, North Carolina, Rhode Island, Virginia, and others. *See, e.g.*, Funds by Name, *https://flagship.vanguard.com/VGApp/hnw/FundsByName*; State Municipal Bond Funds, *http://personal.fidelity.com*; funds available through Charles Schwab, *http://www.schwab.com*.

[14] Between 1980 and 1999, the percentage of municipal bonds held by mutual funds increased twenty-fold, from 1.6% of (...continued)

III. The Proper Tax Treatment Of Interest On Municipal Bonds Is An Important Question That Should Be Decided By This Court.

The Kentucky Court of Appeals held that the federal Constitution prohibits a State from exempting interest earned on in-State municipal bonds from State taxation unless it provides an equivalent exemption for interest earned on out-of-State bonds. *See* Pet. App. A10. The Kentucky Supreme Court has declined to review that decision. *Id.* at A14. The Kentucky court's ruling calls into question the tax treatment of municipal bonds in some 42 States that grant an exemption for some or all in-State bonds but not for out-of-State bonds. *See* Pet. 7-8; The Bond Market Association, *supra* at 30-31. In view of the vital importance of municipal bonds to State and local governments, and the centrality of their tax exempt status, this is plainly an important issue that merits this Court's consideration.

The Kentucky Court of Appeals' decision is squarely in conflict with the decision of the Ohio Court of Appeals in *Shaper* v. *Tracy*, 647 N.E. 2d 550 (1994), which holds that the Commerce Clause does not require States that exempt interest on in-State municipal bonds to grant a similar exemption for out-of-State municipal bonds. The conflict in the lower court decisions creates legal uncertainty that should be resolved without delay. Because the Kentucky Supreme Court has declined to review the decision in this case, only this Court can resolve the uncertainty created by the Kentucky court's decision. [15]

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outstanding bonds in 1980 to 33.7% in 1999. The Bond Market Association, *supra*, at 17.

[15] The decision of the Kentucky Court of Appeals is likely to spur additional litigation on this issue in other States. (...continued)

The Court should decide the question presented by the Petition now rather than awaiting a later case. The issue is squarely presented by this case, and the prior decisions of this Court provide an adequate basis for deciding it. Moreover, municipal bond markets will function most efficiently if the legal uncertainty created by the Kentucky court's decision is resolved promptly.

As a result of the Kentucky court's decision, Kentucky is the only State that is prohibited from exempting interest on in-State municipal bonds unless it grants an equivalent exemption to out-of-State bonds. As noted in the Petition, the States have chosen a variety of approaches to the taxation of out-of-State bonds. While a few States have structured their income tax to exempt income from both in-State and out-of-State bond interest, the majority have adopted an approach that is similar or identical to that of Kentucky. The Bond Market Association, *supra* at 30-31. Regardless of the merits of the question presented, the federal Constitution should apply uniformly to all 50 States.

Indeed, additional litigation is already pending. *See Dunn* v. *Cook*, 635 S.E.2d 604 (N.C. App. 2006) (affirming the certification of a class of taxpayers in order to challenge state income tax on interest earned on municipal bond obligations of States other than North Carolina).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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